

STATE OF MAINE
PUBLIC UTILITIES COMMISSION

Docket No. 97-344

June 19, 1997

NEW ENGLAND TELEPHONE & TELEGRAPH
COMPANY d/b/a NYNEX
Mid-Term Review of AFOR

NOTICE OF INVESTIGATION

WELCH, Chairman; NUGENT and HUNT, Commissioners

By this Notice of Investigation, we open a proceeding to conduct a mid-term review of the Alternative Form of Regulation (AFOR) adopted for NYNEX in Docket 94-123. As discussed more specifically in the succeeding sections, during this review we will examine and we seek comments on the following topics: the impact of Internet usage on NYNEX's switched network; the classification of special contracts under the AFOR; the classification of competitive services, in general; and the productivity offset factor used in the Price Regulation Index. In addition, we invite comments on other issues that we should consider during this review.

In our Order of May 15, 1995, in Docket 94-123, Re: Investigation into Regulatory Alternatives for the New England Telephone and Telegraph Company d/b/a NYNEX (hereafter the AFOR Order), we ordered into effect a new plan for regulating NYNEX that eliminated our reliance on traditional cost-based methods of regulation. Under the AFOR, the Commission does not set prices based on the earnings of NYNEX, but rather has established a system by which the prices that NYNEX is allowed to charge for its services are indexed through a formula that accounts for inflation, a productivity offset and a limited number of exogenous factors.

According to the AFOR Order NYNEX's services have been divided into core and non-core categories. Core services prices are subject to the formula-based pricing index, and are further divided into discretionary and nondiscretionary sub-categories, each of which has its own set of pricing rules. Non-core services, consisting mainly of existing broadband and wideband services, as well as new discretionary services and special contracts for customers without competitive alternatives, are not subject to the pricing mechanism, and their prices can be changed to any level at any time, subject to a floor set at the service's long-run marginal cost.

In the AFOR Order we indicated that during the Spring of 1997 we would conduct a proceeding to review limited aspects of that order. The Order described the adequacy of NYNEX's infrastructure in Maine as a potential area for examination at

the mid-AFOR review. While no other areas were explicitly mentioned, we did not intend to limit the mid-term AFOR review exclusively to an examination of infrastructure issues. Rather, we intended to use the mid-AFOR review to examine any issues that might have arisen since the adoption of the AFOR due to changes in legislation, the telecommunications industry in general and the Company's method of operation, and to reconsider aspects of the original Order that might not be functioning as originally intended.

In this Notice we describe some other areas of concern that have come to our attention, and we invite parties to provide comments about those issues and to inform us of any additional areas that may be ripe for our consideration¹.

AREAS OF CONCERN

A. Impact of Internet Usage

In comments filed on April 22, 1997, in Docket 97-079 and through informal discussions with our staff, NYNEX has indicated that an increase is occurring in the average holding times of local calls through its switches due to increasing use of the Internet. NYNEX has asserted that subscribers using the Internet tend to stay on the line longer than those making voice calls, increasing the average length of calls to a level that is well beyond that for which the network was designed. This, in turn, causes switch congestion at certain times and may cause NYNEX some difficulty in meeting the dial tone speed benchmark (i.e., the % of calls that receive a dial tone in over 3 seconds) established pursuant to the AFOR Order. Currently, the fact that local usage is not measured creates an incentive to use voice grade circuits inefficiently to handle data communications, including Internet traffic.

NYNEX asserts that permanent cost-effective solutions to the "Internet problem" are being considered at the federal level, but until those are in place, it might have to invest a significant amount of money in an attempt to meet the AFOR dialing speed benchmark. Such investment might prove inefficient, since the long-term fixes being discussed would discourage the use of the voice network to handle data communications. This is not the type of investment we encourage. Therefore, we will

¹ On June 13, 1997, we initiated a rulemaking and inquiry (Docket No. 97-319) to: (1) Amend Chapter 280 to achieve intrastate access rate levels in Maine that will be less than or equal to then-current interstate levels by May 30, 1999, and (2) Inquire into the impact of our proposed Amendment of Chapter 280 on NYNEX's AFOR. The AFOR Mid-Course Review will be considered concurrently with our Access Rate Parity Rulemaking and Inquiry.

examine whether the dial-tone speed index established in the AFOR Order is still appropriate, and if not, what adjustment should be made, including examining whether the dial tone speed benchmark should be suspended or modified until the "Internet problem" is resolved. Of course, we will examine whether NYNEX should have anticipated the change in traffic holding times and taken any reasonable steps to mitigate the problems that it now claims are occurring. We will also examine whether NYNEX is receiving additional revenue, such as from the installation of second lines, that might mitigate any financial loss that the Company claims is occurring.

B. Special Contract Classification

We will also examine the classification of special contracts between NYNEX and customers who have competitive alternatives. Currently, these contracts are classified as core discretionary and, thus, are included in the calculation of the overall weighted average price of NYNEX's services that is adjusted annually by the change in the Price Regulation Index (PRI). We put special contracts into this category because, "...the revenue contribution above marginal cost will affect other rates for core services," and because, "...customers (usually smaller customers) who do not have similar competitive opportunities should receive the benefit of the greatest amount of contribution toward fixed costs that can be obtained from the customer obtaining the special discounted rate." AFOR Order at 66

An examination of NYNEX's filing in its first annual AFOR Review, Docket 96-440, reveals that, because of the manner in which the PRI-required price changes are calculated, the benefit to other ratepayers from the special contracts' contribution to fixed costs that we surmised in the AFOR Order may not be occurring. If the PRI is negative and thus requires that the overall level of prices be reduced, as was the case with the first annual filing, NYNEX is able to reduce the prices it charges special contract customers and have those reductions count toward the overall price reduction that it is required to make. Therefore, other ratepayers do not benefit and, in fact, may be disadvantaged by the process. Because special contracts are classified as core discretionary, NYNEX can decide whether or not to change the rates of special contract customers. NYNEX either is obligated under the terms of the contacts or believes for competitive reasons that it must reduce the rates of special contract customers when its other toll rates, particularly its Netsaver Plus service rates, are reduced, as occurred with its first annual AFOR filing. While the total PRI-required reduction in NYNEX's revenues was 2.10%, or \$6.957 million, NYNEX proposed reductions totaling \$6.982 million or 2.11%. NYNEX chose to provide \$744,000 (2.75% of special contract revenues) in

reductions to special contract customers, leaving \$6.238 million in actual reductions for other services. Had special contracts been classified as a non-core service, the total required reduction would have been \$6.892 million (2.1% of the total core revenue, which would have been less without the special contracts), but because none of this amount would have been assigned to special contracts, other services would have potentially received larger reductions than actually occurred.

We seek comments about whether we should reclassify special contracts to the non-core category. Such a change would give NYNEX even more discretion over the prices it negotiates, subject only to the incremental cost floor pricing provisions of the Order. In this way, NYNEX would bear the full risk and reap all of the rewards from these competitive situations, and other ratepayers would be insulated from the consequences of NYNEX's decisions to enter into special contracts. We note that we still are required by statute to approve special contracts, but it appears that the current administrative process generally results in an expedited handling of these contracts when filed, and we have not observed any problem with NYNEX's ability to respond swiftly to competitive pressures.

C. Classification of Competitive Services

Third, we will consider the classification of competitive services in general. Since the adoption of the AFOR Order, Congress has passed the Telecommunications Act of 1996 (TelAct '96), which was designed to open all of the telecommunications industry to competition. Even without passage of that law, many aspects of the industry were becoming competitive due to technological advancements and customer demand for more efficient and lower priced options. We will examine the ways in which the AFOR pricing rules affect services that are competitively available or becoming increasingly competitive. We also will consider whether a process should be established that would systematically reclassify services from the nondiscretionary category to the discretionary category, or from core to non-core, as competition develops. To make such a reclassification, we will consider ways of measuring the level of competition for a service, including number of competitors, relative market shares and availability of substitute services. We invite comments on these and other methods that could be used to determine when a service should be considered sufficiently competitive so that regulatory price protection can be eliminated.

In the preceding section, we identified special contracts as one "service" that appears to be a viable candidate for such reclassification, but we believe a general examination

of the service classification rules and policies is warranted. In general, NYNEX should be permitted to compete in providing services to customers with the least degree of regulatory intervention necessary and should assume the risks and obtain the rewards of such competitive activities. We seek comments on which services, if any, might be immediately reclassified. We also seek comments on how to reclassify services over the remainder of the AFOR.

D. Productivity Offset

The fourth area that may be ripe for additional consideration is the productivity offset factor that is included in the PRI formula. We seek comments on whether the 4.5% factor contained in the AFOR Order is still representative of NYNEX's productivity growth, and if not, how we should determine a more appropriate productivity factor. The FCC recently adjusted upward the productivity offset contained in its price cap formula and simultaneously eliminated the optional earnings sharing mechanism from its plan. Our AFOR never contained an earnings sharing mechanism, and we wish to consider whether changed circumstances in the industry have made the productivity offset that we ordered in 1995 to be inaccurate today. Without being all-inclusive, some factors that may influence this decision include: the announced merger of NYNEX and Bell Atlantic; changes in technology; the level of network usage; the amount of NYNEX capacity that may be available to provide competitive services at very low marginal cost; and the passage of TelAct '96, which allows NYNEX, or the combined NYNEX/Bell Atlantic, to enter virtually all areas of the telecommunications industry, albeit with certain restrictions until a more competitive market structure is in place.

If we determine that the current productivity offset factor should be reexamined, we seek comments on how we might expedite the process. For instance, is new information available that could cause the Commission reexamine the evidence and arguments that were proffered in the AFOR case? Alternatively, are there readily available external indices that could inform the Commission's judgment?

In its comments of April 22, 1997, in Docket 97-079 NYNEX asserted that the reclassification of special contracts and of competitive services has the potential to change the balance between rate payers and shareholders that was established in the AFOR Order, and so the entire AFOR mechanism, including the productivity offset, might have to be reconsidered. We recognize the possibility of that result, but it is not our intent to proceed that far in the current review.

To assess the need for and desirability of a complete reconsideration of the AFOR principles and policies, we invite comments on the assertions contained in NYNEX's April 22nd comments regarding the balance established in the AFOR Order. A proceeding of this type would obviously take much longer than is contemplated for the current investigation. If we are convinced that such a proceeding is necessary, we will expand the scope and time frame of the proceeding to allow sufficient time for a complete reconsideration of the findings made in the AFOR Order.

PROCEDURE

The Commission finds that a formal mid-term investigation of the NYNEX AFOR established in Docket 94-123 is warranted, and the investigation will be conducted under provisions of 35-A M.R.S.A. § 1303. Other than to establish the date for filing of initial comments, the Commission will not now establish a schedule for this proceeding, but we invite comments concerning the schedule and whether any hearings are required. We invite an initial round of comments from interested persons on the issues described in the body of this Notice, as well as on any additional issues that should be considered in this investigation. After the initial comments are reviewed, we will determine if hearings are needed, if a technical conference is appropriate, or if some other procedural mechanism will allow us to establish a record on which to base our final decision.

Interested persons should submit their initial comments to us by July 21, 1997. We intend to complete this proceeding in time to implement any decisions with the annual AFOR price change that is due to be effective on December 1st of this year.

Notice of this proceeding will be sent to all parties and interested persons in Docket 94-123, all independent local exchange carriers in Maine and any competitive local exchange carrier that has applied for authority to operate in Maine or has signed an interconnection agreement with NYNEX or has requested arbitration by the Commission.

BY ORDER OF THE COMMISSION

Dennis L. Keschl
Acting Administrative Director

COMMISSIONERS VOTING FOR: Welch
Nugent
Hunt

NOTICE OF RIGHTS TO REVIEW OR APPEAL

5 M.R.S.A. § 9061 requires the Public Utilities Commission to give each party to an adjudicatory proceeding written notice of the party's rights to review or appeal of its decision made at the conclusion of the adjudicatory proceeding. The methods of adjudicatory proceedings are as follows:

1. Reconsideration of the Commission's Order may be requested under Section 1004 of the Commission's Rules of Practice and Procedure (65-407 C.M.R. 110) within 20 days of the date of the Order by filing a petition with the Commission stating the grounds upon which consideration is sought.
2. Appeal of a final decision of the Commission may be taken to the Law Court by filing, within 30 days of the date of the Order, a Notice of Appeal with the Administrative Director of the Commission, pursuant to 35-A M.R.S.A. § 1320(1)-(4) and the Maine Rules of Civil Procedure, Rule 73 et seq.
3. Additional court review of constitutional issues or issues involving the justness or reasonableness of rates may be had by the filing of an appeal with the Law Court, pursuant to 35-A M.R.S.A. § 1320(5).

Note: The attachment of this Notice to a document does not indicate the Commission's view that the particular document may be subject to review or appeal. Similarly, the failure of the Commission to attach a copy of this Notice to a document does not indicate the Commission's view that the document is not subject to review or appeal.